

**REPORT BY THE
AUDITOR GENERAL
OF CALIFORNIA**

**A REVIEW OF THE DEPARTMENT OF HEALTH SERVICES'
ESTIMATES OF SAVINGS RESULTING FROM
THE MEDI-CAL DRUG DISCOUNT PROGRAM**



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P-113

Honorable Robert J. Campbell, Chairman
Members, Joint Legislative Audit Committee
State Capitol, Room 2163
Sacramento, California 95814

Dear Mr. Chairman and Members:

Summary

The Department of Health Services (department) will not realize a \$50 million (\$23.9 million, State's General Fund) savings through a drug discount program as it had estimated initially in the Governor's Budget for fiscal year 1990-91. The department based its \$50 million estimate, which was developed in May 1990 before the establishment of the drug discount program, on the assumption that it would receive a 30 percent savings beginning January 1, 1991, on the ingredient cost of all prescription drugs purchased under the California Medical Assistance Program (Medi-Cal). However, the department based this estimate on a different drug discount program from the program that was actually implemented. Therefore the department's \$50 million estimate of savings does not accurately reflect the fiscal impact of the drug discount program the department is currently operating.

Since May 1990, the department has twice revised its estimate of savings that will result from the drug discount program that was actually implemented. The department based its current estimate, prepared in March 1991, on contracts negotiated with 15 drug

manufacturers. This estimate projects a net savings of approximately \$3.3 million (\$1.65 million, State's General Fund) for fiscal year 1990-91.

The Legislative Analyst's Office (LAO), in its analysis of the 1991-92 Budget Bill, estimated that instead of saving money the drug discount program would cost the State. Specifically, according to the LAO's analysis of the 1991-92 Budget Bill, the drug discount program may result in net costs to the State of approximately \$2.5 million (General Fund) in both fiscal years 1990-91 and 1991-92. However, the assumptions that underlie the LAO's estimates differ significantly from the assumptions that underlie the department's estimates. The LAO's estimates include the cost of adding Mevacor, a drug used to reduce cholesterol levels, to the list of contract drugs and the department's cost of administering the program. In contrast, the department's estimates exclude the cost of adding Mevacor and the cost of administering the program.

In our opinion, the department was correct to exclude the cost of adding Mevacor when it calculated the fiscal impact of the drug discount program. However, the department should have included the program's administrative costs when it calculated the costs and savings to reflect more accurately the fiscal impact of the program.

During our review of estimates for a sample of drugs covered under contract, we found errors in some of the department's costs or savings. The net effect of the errors we identified, based on the first 9 contracts, was an approximate 3.2 percent understatement of savings for fiscal year 1991-92, while the net effect of the errors for all 15 contracts was an approximate 1.5 percent overstatement of savings for fiscal year 1991-92.

Background

The Medi-Cal drug discount program was designed to ensure the availability of necessary drugs to Medi-Cal beneficiaries at an acceptable cost to the State. Of the \$8.1 billion California is projected to spend for Medi-Cal benefits during fiscal year 1990-91, approximately \$638 million (7.9 percent) represents the cost of prescribed drugs. According to the Governor's Budget for fiscal year 1990-91, Medi-Cal expenditures for drugs have continually increased in recent years, from 5.5 percent of total Medi-Cal expenditures in fiscal year 1978-79 to 7.9 percent in fiscal year 1990-91.

The drug discount program was established in July 1990. According to the department's acting chief negotiator, the primary objective of this program is to obtain significant price discounts on pharmaceuticals. To accomplish this, the department can take advantage of discount prices that manufacturers provide to other high-volume purchasers of drugs. Under this program, Section 14105.33 of the Welfare and Institutions Code authorizes the department to contract with drug manufacturers for price rebates on drugs that are purchased through Medi-Cal. The amount of a rebate, which is defined in Section 14105.31 of the code as an equalization payment amount, is based on the difference between the manufacturer's price charged to wholesalers and the manufacturer's best price. Best price is defined in the same code section as the negotiated price or the manufacturer's lowest price available to any other customer.

Another objective of the drug discount program is to make a greater selection of drugs available to Medi-Cal beneficiaries. Before this program was established, drugs for which Medi-Cal would reimburse could be added only by regulation. Now the department may add drugs to the list of contract drugs when the department and manufacturers negotiate rebate contracts, with certain exceptions. In computing the savings associated with the drug discount program, both the costs of adding drugs to the list and the savings associated with manufacturer rebates must be considered. Adding drugs to the list of contract drugs does not always result in increased costs. For example, a less expensive drug may be added to replace another drug, yielding a savings from the addition of the drug.

**Scope and
Methodology**

The purpose of this review was to determine the discrepancy between the Governor's Budget and the LAO's analysis regarding the savings to be generated from the drug discount program and to assess the department's methodology for estimating savings. This included determining whether the department's assumptions were consistent with current data and whether the department's methodology was logically and mathematically sound.

To review the department's estimate for a \$50 million savings (\$23.9 million, State's General Fund) in fiscal year 1990-91, we analyzed the department's supporting documentation, its methodology, and its assumptions used in this May 1990 estimate. We also interviewed department officials regarding the estimate. The Medi-Cal program enjoys federal financial participation. Therefore, we generally present two sets of estimates: the total estimate (federal and state funds) and the State's General Fund estimate.

To review the department's revised estimates of net savings in fiscal year 1990-91 and its estimates for 1991-92, we first identified the contracts used in developing the estimates. To determine the accuracy of the estimates, we then reviewed the methodology, assumptions, and mathematical calculations used in estimating the costs and savings for a sample of drugs included in the contracts. However, in some cases we either could not or did not independently verify all of the information used in the estimates of costs and savings.

To determine how the LAO estimated that the drug discount program may result in net costs in fiscal years 1990-91 and 1991-92, we consulted the LAO's analysis of the 1991-92 Budget Bill, and we interviewed a senior fiscal and policy analyst in the LAO's health section.

**The
Department's
Estimated
Savings for
Fiscal Year
1990-91**

The department initially estimated that it would realize a savings of \$50 million (\$23.9 million, General Fund) in fiscal year 1990-91 through the implementation of a drug discount program. This estimate was developed in May 1990, before the drug discount program was established. In general, this estimate assumed a 30 percent savings beginning January 1, 1991, on the ingredient cost of all prescription drugs purchased under the Medi-Cal program. However, according to the deputy director of medical care services, the \$50 million savings was based on the department's analysis of various proposals for program implementation, such as contracting with wholesalers for the distribution of drugs or taking possession of purchased pharmaceuticals. In contrast, under the current drug discount program, Medi-Cal beneficiaries purchase prescription drugs from retail pharmacies, the pharmacies are reimbursed through the Medi-Cal program, and the Medi-Cal program receives price discounts on some of the drugs from the manufacturers.

According to the department's deputy director of medical care services, the \$50 million savings estimate was based on the department's best estimate of the savings achievable given then-current expenditures and various proposals for program implementation. Because the current program is not the same as the proposed programs upon which the department based its \$50 million estimate of savings, this estimate does not accurately reflect the fiscal impact of the drug discount program.

Revised Estimates

The department has twice revised its savings estimate for fiscal year 1990-91. Unlike the assumptions used in estimating the \$50 million savings, the department based its revised estimates on its contracts with drug manufacturers. The department's revised estimates involve an analysis of the costs or savings associated with each drug included in contracts with drug manufacturers. These estimates take into consideration such factors as historical utilization and discount rates projected by the manufacturers.

In November 1990, department records indicated that it would achieve net savings of approximately \$1 million (\$500,000, General Fund) for fiscal year 1990-91 based on its contracts with 9 drug manufacturers. As of March 1991, department records indicated that it would achieve net savings of approximately \$3.3 million (\$1.65 million, General Fund) for fiscal year 1990-91 based on its contracts with 15 drug manufacturers. The department's projected savings would result from the net effect of the costs of adding new drugs to the list of contract drugs and the savings from price rebates negotiated between drug manufacturers and the department.

**The
Department's
Estimated
Net Savings
for Fiscal Year
1991-92**

In addition to the revised estimate of savings for fiscal year 1990-91 that the department made in November 1990, it also first estimated its savings from the drug discount program for fiscal year 1991-92 in November 1990. At this time, the department estimated that it would realize a net savings of approximately \$2 million (\$1 million, General Fund) in fiscal year 1991-92. At the time that it developed this estimate, the department had contracts with 9 drug manufacturers.

In March 1991, the department revised this savings estimate. By this time, the department had contracts with a total of 15 drug manufacturers, which the department estimates will result in a net savings of approximately \$7.3 million (\$3.65 million, General Fund).

**The LAO's
Estimated
Net Costs for
Fiscal Years
1990-91 and
1991-92**

According to the LAO's analysis of the 1991-92 Budget Bill, the Medi-Cal drug discount program may result in net costs to the State of approximately \$2.5 million (General Fund) in each of fiscal year 1990-91 and 1991-92 in contrast to the department's estimate of net savings estimates in both years. The LAO's estimates are based primarily on estimates provided by the department and are based on contracts negotiated with nine drug manufacturers.

The LAO's estimates differ from the department's because of the different ways the LAO and the department handled the cost of adding the drug Mevacor. The LAO included the cost of adding Mevacor to the list of contract drugs in its estimates whereas the department did not include the cost of adding Mevacor. However, both the department and the LAO included rebates from drug contracts, including Mevacor, in their calculations of the fiscal impact of the drug discount program for fiscal years 1990-91 and 1991-92.

The LAO and the department also treated differently the cost to the department of administering the drug discount program. The LAO included this cost in its estimate whereas the department did not.

Table 1 shows the discrepancy between the department's and the LAO's estimates for fiscal year 1990-91.

Table 1 **Estimates of Effect of
Drug Discount Program on General Fund
Fiscal Year 1990-91
(in thousands)**

	Department Estimate	LAO Estimate
Cost of adding new drugs to list of contract drugs, excluding Mevacor	\$ 2,706	\$ 2,706
Cost of adding Mevacor to list of contract drugs	0	2,288
Rebates from drug contracts, including Mevacor	(3,206)	(3,206)
Total, before administrative costs	\$ (500)	\$ 1,788
Administrative costs	0	659
General Fund Total	\$ (500)	\$ 2,447

Sources: Department of Health Services and Legislative Analyst's Office, based on contracts with nine drug manufacturers.

According to the deputy director of medical care services, the cost of adding Mevacor to the list of contract drugs should not be included in the calculation of the drug discount program's fiscal impact because the Department of Finance specified that funds were available in the Governor's Budget for fiscal year 1990-91 to fund the addition of Mevacor to the list of contract drugs.

Even though the LAO acknowledges that there was a separate appropriation for Mevacor in the 1990-91 budget, a senior fiscal and policy analyst in the LAO health section stated that the cost of adding Mevacor should be included in the calculation of the drug discount program's fiscal impact for several reasons. First, Mevacor was added to the list of contract drugs by rebate contract through the drug discount program. Second, the cost of other drugs added by the same contract are reflected in the department's estimate. Finally, since the department's estimate includes a rebate associated with Mevacor, it should also reflect the costs associated with Mevacor.

According to the department's acting chief negotiator, the costs of administering the program are not reflected in department estimates because administrative costs are budgeted separately. The department's estimates are based solely on the net effect of costs and savings from contracts negotiated with drug manufacturers. In contrast, the LAO includes administrative costs in its analysis because these costs reflect the cost of new staff added specifically for the drug discount program.

Table 2 shows the discrepancy between the department's and the LAO's estimates for fiscal year 1991-92.

Table 2 Estimates of Effect of Drug Discount Program on General Fund Fiscal Year 1991-92 (in thousands)

	Department Estimate	LAO Estimate
Cost of adding new drugs to list of contract drugs, excluding Mevacor	\$ 4,801	\$ 4,801
Cost of adding Mevacor to list of contract drugs	0	2,796
Rebates from drug contracts, including Mevacor	(5,879)	(5,879)
Total, before administrative costs	\$(1,078)	\$ 1,718
Administrative costs	0	784
General Fund Total	\$(1,078)	\$ 2,502

Sources: Department of Health Services and Legislative Analyst's Office, based on contracts with nine drug manufacturers.

During our review of this issue, we found that Mevacor was not added to the list of contract drugs by contract. Rather, it was added to the Medi-Cal drug formulary before the drug discount program was established. Therefore, in our opinion, the cost associated with Mevacor should not be considered in the calculation of the fiscal impact of the drug discount program. Conversely, the rebate associated with Mevacor resulted from the adoption of legislation that implemented the drug discount program. Therefore, in our opinion, the rebate associated with Mevacor is properly included in the calculation of the drug discount program's fiscal impact.

However, because the department excluded the administrative costs for the drug discount program, its estimates do not fully reflect the costs associated with the program.

If the department had added budgeted administrative costs to its estimates, the fiscal impact of the drug discount program would have been a net cost of \$159,000 in fiscal year 1990-91 and a net savings of \$294,000 in fiscal year 1991-92, based on nine contracts.

**A Review of
the Accuracy
of the
Department's
Estimates**

The department used several methodologies to estimate the cost and savings associated with drugs covered under contracts. The methodologies differed depending on whether the drug was already on the list of contract drugs or whether it was being added to the list of contract drugs. In addition, the methodologies for estimating costs and for estimating savings differed. The department generally relied on its own historical utilization data for estimating savings on drugs already on the list of contract drugs. The department made assumptions regarding the anticipated market share that drugs would capture when they were replacing other drugs already on the list of contract drugs.

According to the department's acting chief negotiator, developing cost and savings estimates for drugs is a three-step process. First, a preliminary fiscal analysis for each drug is prepared in advance of contract negotiations. Second, additional information such as the rebate or discount rate is obtained during the negotiating process. Finally, at the conclusion of negotiations with each drug manufacturer, the department finalizes and summarizes the net cost and savings for each drug product.

**A Review of the Department's
Estimates Based on Nine Contracts**

We reviewed a judgmental sample of 17 costs or savings estimates out of a total of 77 (22.1 percent) estimates for drugs covered under six of the first nine contracts. The department had calculated 9 (52.9 percent) of the 17 estimates incorrectly. Six of the 9 errors were related to savings estimates and ranged from a \$400,000 understatement to a \$185,000 overstatement. The remaining 3 errors were related to cost estimates and ranged from a \$98,000 understatement to a \$50,000 overstatement. The net effect of the errors identified was an approximate \$146,000 understatement of savings for fiscal year 1991-92; this represents approximately 3.2 percent of the dollar amount we tested.

A Review of the Department's Estimates Based on 15 Contracts

We reviewed a judgmental sample of 27 (16.6 percent) costs or savings estimates out of a total of 163 estimates for drugs covered under 10 of a total of 15 contracts. The department had calculated 15 (55.6 percent) of the 27 estimates incorrectly. This number includes incorrect estimates identified during our review of the department's estimates based on 9 contracts. Eleven of the 15 errors were related to savings estimates and ranged from a \$400,000 understatement to a \$185,000 overstatement. In one case, savings were understated by \$89,000 because the analysis was based on a rebate discount that was 2 percentage points less than the rebate discount actually negotiated in the contract. The remaining 4 errors were related to cost estimates and ranged from a \$444,000 understatement to a \$50,000 overstatement. In one of these cases, a cost was overstated by \$50,000 because the analysis was based on a wrong cost for the drug.

The net effect of the errors identified was an approximate \$120,000 overstatement of savings for fiscal year 1991-92, which represents approximately 1.5 percent of the dollar amount we tested. The remaining 12 of 27 costs or savings estimates were calculated correctly. However, in some cases we either could not or did not independently verify all of the information used in those calculations.

While the net effect of the errors we identified was only approximately 1.5 percent, our analysis revealed that over 50 percent of the estimates we reviewed were calculated incorrectly. We have informed the department of the errors we identified, and the department's acting chief negotiator has agreed that the drug discount program will evaluate its estimating process.

We conducted this review under the authority vested in the auditor general by Section 10500 et seq. of the California Government Code and according to generally accepted governmental auditing standards. We limited our review to those areas specified in the audit scope section of this letter report.

Respectfully submitted,



KURT R. SJOBERG
Auditor General (acting)

**Response to
the Audit**

Health and Welfare Agency
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June 13, 1991

Mr. Kurt R. Sjoberg
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Dear Mr. Sjoberg:

Secretary Gould has asked me to respond to your draft report of June 1991 which reviews the Department of Health Services' estimate of savings resulting from the Medi-Cal Drug Discount Program.

The Department is in agreement with the accuracy of the findings contained in the report. The Department also acknowledges that the program's administrative cost should be included when determining the overall fiscal impact of the Medi-Cal Drug Discount Program (this cost was excluded from the Department's original estimate since it had been budgeted for separately).

The majority of problems identified in your report stem from deficiencies in our record keeping. As a result of your review, the Department has made, and will continue to make, changes in this area to improve our record keeping. Such changes will reduce the possibility of errors in our calculations as well as make auditing of information contained in fiscal estimates easier to independently verify.

The Department appreciates the time and effort taken by your staff in identifying the deficiencies contained in our fiscal estimates.

Sincerely,

Molly Joel Coye, M.D., M.P.H.
Director